Share System: Toward Enterprise Reform in the PRC

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MBA PROJECT REPORT

Presented to

The Graduate School

In Partial Fulfilment

of the Requirements for the Degree of

MASTER OF BUSINESS ADMINISTRATION

TWO-YEAR MBA PROGRAMME

THE CHINESE UNIVERSITY OF HONG KONG

May 1993

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Abstract

Share system reform is a measure to specify the property rights and separate government from enterprise management. It provides a direction for PRC's enterprise reform, and is expected to rationalize the behaviour of enterprises under hard budget constraints. But there exist some problems in applying share system to achieve the intended purposes. The government is still the owner of the state assets. So a way to liberalize enterprises from government administrative control is to deny the government governance in the enterprises.

CHAPTER I

Introduction

The management in China's traditional state enterprises is administrative, heavily controlled by the government. It has led to the inefficient operation of state enterprises.

Kornai (1980) coined the concept of "soft budget constraint" to describe the relaxation of budget in state enterprises, and Kornai (1986) pointed out that the combination of government and enterprises was the origin of the inefficiency.

In as early as 1986, PRC's scholars recognised the idea that share system might be the right way to achieve enterprise reform. Han (1986) and Liu (1986) emphasized that state shareholding might separate ownership from management.

From 1986 to early 1989, after detailed analyses of the enterprise reform, many researchers and practitioners advocated the share system proposal. Dong (1988), Hua & Zhang & Ruo (1988), Tang (1988), Zhang (1989) probed deeply into the feasibility of the transplantation of share system with public ownership. By applying western theory of property rights to analyze the share system, they pointed out that there existed an ambiguous property rights relationship in state enterprises. So they advocated the share system because it would specify the property rights.

The "June 4th event" left people to retrospect on the ten-year reform. And from mid-1990, more and more people have stood up to support the adaption of share system. Song (1990) pointed out that it was time to transform the traditional public ownership.

Meanwhile, there was a movement for privatization in capitalist countries. Lord (1990), and Moore (1992) summarized the reasons for privatization, i.e. the discard of state enterprises: 1. encourage efficiency and effectiveness, 2. raise capital, 3. widen the capital market, 4. promote competition, 5. freedom in decision-making, 6. set up market culture. They pointed out that the most serious disadvantage of state enterprises was the subordination of commercial objectives to the political process.

In this article, I apply the elements drawn from the agency theory, from the theory of property rights and from Marx's historical materialism to analyze the PRC's state enterprises.

Then, I discuss the role of share system in the transfor-mation of management mechanism in state enterprises. Finally, with a case analysis of one of the earliest joint-stock enterprise--Shanghai Feilo Company Ltd, I inquire into the problems which occurred in the transplantation of share system and try to find out feasible countermeasures.

Eisenhardt (1989) reviewed the agency theory and indicated that the theory is concerned with resolving problems that occur in principal-agent relationships. The theory stated two important concepts: 1.the "inherent goal conflicts" between the principal and the agent, 2. the "governance mechanisms", which should be designed to limit the agent's self-serving behaviour.

The agency theory is applied in this paper to analyze the principal (government) - agent (managers) relationship and the behaviour of managers in state enterprises.

Siegel & Rammauskas-Marconi (1990) defined the concept of "slacks" as the difference between the resources that are actually necessary to efficiently complete a task and the larger amount of resources that are earmarked for the task.

Among PRC's state enterprises, there exists serious management shirking and slacks, and, the only governance mechanism is the bureaucratic administration. These problems can be attributed to the combination of state apparatus and the government ownership of state assets.

Marx in his famous book "Capital --- A critique of political economy" indicated that the socialist society should give the producer "individual property based on the acquisitions of the capitalist era" (P837) and there should be a distinction between the economic foundation (enterprises) and the superstructure (government).

Coase (1937, 1960), Alchain (1972) and Demsetz (1988) indicated the importance of the specification of property rights to allocate rewards and costs properly and reasonably.

Thus share system, which can make the separation of ownership from control, is recommended and introduced to state enterprises to specify the property rights and reward allocations.

In order to have an idea of the actual application of share system in PRC, I will also investigate one large joint-stock company - Shanghai Feilo Co. Ltd. - based on interviews with its general manager. In sofar as the share system reform in PRC state enterprises, its most important intended purpose on the separation of government (superstructure) and enterprise has not yet been achieved. To ensure the success of share system reform, it is recommended to set up a pure economic institution - state assets investing company, to be directly under the National Congress, purposes to ultimately eliminate the government's administrative intervention in enterprises.

CHAPTER II

China's state enterprises and their management

2.1. The operation of the state enterprise system

According to the traditional theory of socialism, i.e. in a society of public ownership, all social productive materials should belong to the people as a whole, so that no particular person can own any particular property except consumer goods. Since the people as a whole form the state, thus public ownership appears in the form of state ownership.

Theoretically, state ownership can represent public ownership; but practically, "state" is the government and the public assets are finally managed by those bureaucrats in the government. In this alienation, "state", which is comprised of all citizens, is replaced by the government, which is an external organ to every citizen. Citizens give up the management rights of public assets to the bureaucrats but without gaining in return any direct measures to monitor them.

What constrains the management of the bureaucrats is the planned production targets set by their immediate superiors. Each year, the Central Planning Committee assigns production targets of every industry to each provincial local government. The local government then decomposes those targets to every bureau. A bureau is responsible for the production of products of one specific industry. Then each bureau assigns targets to each company. A company is responsible for the production of a series of products in one industry. And at last, each company places production targets to each factory, which is the basic production unit in China as elsewhere.

Thus, what a manager of a factory does is to meet the production target without paying much attention to the market. And this leads to an economy which is "quantity first, quality second". The government replaces market with a central planning system. This top-down operational system pre-supposes precise prediction of the productivity of both labour and machine in each industry and planners are charged with an almost impossible task of estimating the exact demand of consumers for each product. The most typical characteristic of the traditional state enterprises is the lack of independent economic target and benefit. All decisions of input and output are made by different levels of government through planning departments and the enterprise's supervisory institutions.

Moore (1992) pointed out the most serious problem of state enterprises as political priorities took precedence over commercial ones. State ownership of industry means a subordination of commercial objectives to the political process. Lord (1990) also indicated political interferences in decision-makings of state enterprises.

The highly centralized planning system turns state enterprises into subsidiaries of the government while the daily operation of those enterprises is accomplished through administrative orders via the secretary of the Party Committee of each enterprise. Accordingly, the division-responsibility system, held by the Party Committee, is implemented in those enterprises. The secretary of the Party Committee of each enterprise is the highest position in an enterprise and the manager is but an executor of the decisions made by the Committee. In essence, this fully represents a long-held principle in the Chinese Communist Party: the Party should lead everything.

If people were machines, it might be plausible to run such a system. But unfortunately or fortunately rather, there are too many uncertainties which make the centrally planned economy inefficient.

2.2. Agent problems in the management of state enterprises

Public ownership has degenerated into state ownership, then into government ownership, and finally into party ownership. The ultimate "principals" of the public assets - in the terminology of the Agency Theory - are all the citizens, but they have become nominal, whereas, their real property rights have been emptied. The representative of the principal is the government. So the government sets up a direct agent relationship with the managers. As "agents" of all the citizens, bureaucrats at different levels of the government control and "own" the management right of public assets.

In fact, there are two levels of agent relationship in this system. At the first level, the government acts as the agent of the citizens, with the National Congress is the "governance mechanism" monitoring the government. At the second level, the managers of state enterprises behave as agents of the government, and the bureaucratic administration is the only governance mechanism. In this paper, because of its relevance to state enterprises, I only concentrate on the discussion of the second level of the above two mentioned agent relationships.

2.2.1. Managers as agents of the government

The salary level of a manager in state enterprises is set by the government according to his bureaucratic status, which in turn is determined by the number of employees and the annual output of the enterprise. Thus, in order to ultimately increase his own benefits, a manager is stimulated to increase the size of his enterprise.

The state takes all the profit of state enterprises. The managers have no residual claims, let alone to garner all the return from their efforts. Thus the managers are inclined to just meet average performance expectations to keep their positions. Meanwhile, they maximize their benefits by shirking their tasks, directing resources from the enterprise to their own use and pursuing goals such as organizational size expansion which enhance their bureaucratic status and enlarge their personal powers. Later, with the analysis of "soft budget constraints", I shall show that such expansions are at the expense of the welfare of the principals--the state. This fully reflects the "inherent goal conflicts" between the principal and the agent (Eisenhardt, 1989).

In socialist state enterprises, there's no *economic* monitor mechanism to prevent such kind of shirking. There is only one *political* monitor mechanism - bureaucratic administration. Each bureaucrat is only obedient to his superiors and his career path is to become a bureaucrat of higher level. The bureaucrat's performance is evaluated by the accomplishment of the planned target assigned to him. So in order to meet the target more easy, managers (bureaucrats) of each level intend to add slacks as many as possible through various ways.

Slack is the difference between the resources that are actually necessary to efficiently complete a task and the larger amount of resources that are earmarked for the task. The bureaucrats create slacks by underestimating revenues, overestimating costs, or overstating the amount of inputs necessary to manufacture a unit of output, in order to provide a safety margin to meet the production target. This cushion of extra resources relieves the target-related pressures and frustrations often induced by tight-targets. It gives the bureaucrats more flexibility and greater certainty of achieving their personal and organizational goals (Siegel & Rammauskas-Marconi, 1990). In order to accomplish their work easily, workers at the factory level do the same as their managers by adding slacks.

Slacks are covered up through good personal relationship with immediate superiors and private benefit-sharing. Managers are supposed to be under the surveillance of the workers' congress in each enterprise. But since the workers' welfare is linked to the accomplishment of the production target, workers in an enterprise likewise want to take advantages from the society and thus those managers who are most competent in bargaining production targets with superiors are the most popular.

Therefore, political governance replaces economic governance mechanism of the market through competitive efficiency and production effectiveness. Slacks and inefficiency are of a massive scale in the production process of state enterprises, but are covered-up by personal relationship and private benefit-sharing in all levels of state enterprises. Slacks result in huge sum of wastes, significant inefficiency and low productivity in the production process. Slacks render meaningless budgets, production targets and performance standards. More importantly, slacks undermine the drive for organizational efficiency. To achieve organizational control, actual performances should be compared to reasonable standards. Without meaningful standards, no control can be implemented.

2.3. Soft budget constraints

Kornai coined the concept of "soft budget constraint" in his book "Economics of shortage" (1980). It describes the strict relationship between earnings and expenditure that when state enterprises expect that excess expenditure will finally be paid by some other institutions, typically the state, in the form of "soft taxation", "soft subsidies", "soft prices" and "soft credits", there occurs the relaxation of the budget (Kornai, 1980).

Under the soft budget constraints, the operating loss of state enterprises may also be covered by external financial assistances, such as fiscal subsidies, low-priced raw material allocation, credits with lower interest rate, etc. Taxation, pricing and input allocation are subject to arbitrary bargaining between state authorities and enterprises.

2.3.1. Implications

There are two categories of implication for these soft budget constraints on state enterprises: ex ante and ex post.

Ex ante implications:

First, state enterprises would care less about the price signals. Since the achievement of planned production targets has its priority, so as long as the enterprise meets the target, it can obtain various assistances from the government. It would care less about the possible financial outcomes of its decision makings. In fact, its decisions on input purchasing or investment are made in order to achieve the assigned production targets, not for the maximization of profit under binding constraints (Kornai, 1980). This kind of unconstrained behaviour further distorts relative prices and disturbs the working of the rational price system, including the pricing of capital.

Second, there is exogeneity of the price system (Kornai, 1980) such that the price level of inputs and outputs is determined by the government. Thus, when enterprises run into financial difficulties, they will try their best to affect their output price or input price through bargaining with state authorities in charge of price controls. It is much easier to obtain profit through the bargaining than to improve operating efficiency.

Third, because of the easy availability of external financial assistances, enterprises are subject to low levels of motivation to increase their efficiencies (Kornai,1986).

Ex post implications:

Government fiscal organizations intervene in the enterprise operation ex post with tax rate adjustments, subsidies, or even credits to correct some portion of allocation inefficiency of resources which results from the distorted price system and the soft budget constraints (Kornai, 1980, 1986). But, as we have discussed, the price distortion and the soft budget constraints are themselves resulted from the plan system and the availability of fiscal intervention. So it turns out to be a vicious cycle.

Ex post fiscal intervention often involves bargaining because of the problem of information. By manipulating information reported to the state authorities, enterprises can affect determination of the tax, subsidies, or credit to their own advantage, though not necessarily to improve efficiency. Since the success of central planning system relies heavily on the timely and correct information, this information manipulation and time lag eventually lead to inadequate plans and distorted price system.

State authorities, especially local authorities, also have their own nonofficial interests. The bureaucrats, who are in charge of the allocation of subsidies and other financial assistances, can exchange their power for their own benefits. So they also involve into the bargaining their superiors to obtain a higher quota of those financial assistances.

State enterprises are administered by the government under the central planning system, thus the lack of independent economic target and benefit. There is only one political "governance mechanism" to monitor the behaviour of the managers. This distorts their behaviour and makes the managers choose a higher bureaucratic status as their career path. Thus, without economic "governance mechanism", the government can not solve the problems of slacks, shirking and soft budget constraints.

In order to set up an economic "governance mechanism", we should first probe deeply into the origin of the inefficient operation of the state enterprises.

CHAPTER III

Property rights and the origin of inefficiency

3.1. Enterprises and government apparatus

The traditional state enterprises have two important features:

1. Their purpose is to achieve both economic and noneconomic goals. That is, the state enterprises should help the government to provide employment, maintain social stability, etc.

2. Their performances are evaluated not only by the magnitude of its profit, but also by their political and economic relationships with the external environments: the government, the community and etc.

These two features reflect a unification in functions of both the enterprises and the government apparatus. This uneasy unification originates from the ambiguous property rights relationship between the state and the enterprises. It eventually leads to persistent slacks and shirking due to soft budget constraint, and inefficient administrative control. This functional unification between the government apparatus and state enterprises breeches Marxism.

According to Marx's historical materialism, the economic foundation of a society is the totality of relations of production appropriate to a given stage in the development of material forces of production. A legal and political superstructure arises on, and definite forms of social consciousness correspond to this economic foundation. Accordingly, there should be a necessary distinction between this economic foundation and the superstructure (including the state, the government) (Marx, 1906).

The traditional state ownership system implies that the state is the subject of both the superstructure and the economic foundation, and that the state apparatus replaces the internal law of motion of the economic foundation. The economy is "administered" by the state apparatus, and the market is replaced by the central plan (Hua, Zhang and Ruo, 1988).

Moreover, according to Marxism, relations of production should be determined by the development of social productive forces. But in traditional state ownership, the relations of production are determined arbitrarily by demands of the state administrative structure. This turns Marxism up-side down.

Thus, the administrative methods used in the operation of the government are transplanted to the management of the economy and enterprises. This state adminstration of the economy cuts voluntary horizontal relationships among enterprises, and instead imposes a vertical planning system. As a result, inter- and intra-enterprise economic relationships are replaced by a strict bureaucratic relationship, and enterprises become the property of supervisory government institutions. Moreover, the state apparatus (part of the superstructure) is contaminated by commercialism, owing to its direct involvement in the management of the economy. Corruptions prevail with the exchange of bureaucratic power for monetary benefits.

So the origin of the inefficiency of Chinese economy lies in the inadequate form of public ownership.

3.2. Specification of property rights

In his famous book "Capital --- A critique of political economy", Karl Marx wrote:

> "The capitalist mode of appropriation, the result of the capitalist mode of production, produces capitalist private property. This is the first negation of individual private property, as founded on the labour of the proprietor. But capitalist production begets, with the inexorability of a law of Nature, its own negation. It is the negation of negation. This does not re-establish private property for the producer, but gives him individual property based on the acquisitions of the capitalist era: i.e., on co-operation and the possession in common of the land and of the means of production." (P837, 1906)

What does it mean? Perhaps an analysis of state enterprises with property rights theory may shed some light on it.

Coase (1937, 1960) indicated the importance of the specification and arrangement of property rights in economy. The specification of individual property rights determines how costs and rewards will be allocated among the members of an organization through contracts. Pryor (1972) defines property rights as "a bundle of rights or a set of relations between people with regard to some good, services, or `thing'; such rights must have economic value and must be enforced in some societally recognized manner".

Property rights are a social means to help social individuals form their expectations about how they get benefits from and pay expenses for the use of property. So there exists a close relationship between property rights and externalities (Alchain 1972). Property rights clarify the economic relationship among individuals, and provide guiding incentives to achieve a great internalization of externalities.

In order to internalize the external costs and benefits, a society should guarantee the establishment of ownership and a property right adjustment. The clarification of property rights makes the reasonable exchange of property available and forms the market (Demsetz, 1988).

Tang (1988) pointed out that the property rights of the traditional public ownership were ambiguous and there was a need to specify the property rights. He indicated that the specification of the property rights would secure: 1. investment efficiency principle to owners, 2. asset appreciation principle to managers, 3. contribution and distribution principle to labours.

Public ownership means a right which can be exercised by all members of the public. It denies to the state or to individual citizens to interfere with any person's exercise of publicly owned rights. The soft budget constraint in state enterprises, however, reflects that there lacks a mechanism to concentrate the cost associated with any person's exercise of his public right on that person.

If a person seeks to maximize the value of his public rights, he will tend to overuse the public assets because some of the costs of his behaviour are borne by others. Public property results in great externalities. It rules out the "pay-to-use-the-property" principle. Also, every owner of a public asset can not exclude others from enjoying the fruits of his efforts. This is the widespread free-riding phenomenon in state enterprises.

3.3. Institutional arrangement

In modern enterprises, various types of human and material resources cooperate to produce products. And the means of production of enterprises is in common possession and not only belongs to one person. This is a team production (Demsetz, 1988). It becomes a problem how to reward and induce the members of a team to work efficiently without shirking. This is the concept of "governance mechanisms" of the agency theory (Eisenhardt, 1989). If it were costless to detect shirking, no member would have an incentive to shirk because nobody could impose the cost of his shirking onto the others.

Based on the cost-efficient principle, in each enterprise, only a certain level of efforts will be made to equate the marginal gains (efficiency improvement from the avoidance of shirking) of detection activity to the marginal costs of detection.

One method of reducing shirking is to appoint someone to specialize as a monitor to check the input performance of team members. But who will monitor the monitor? Constraints on the monitors are the market competition offered by other potential monitors and the title given to him to receive any residual monitors and the title given to him to receive any residual product above prescribed amounts.

Zhang (1989) addressed that institutional arrangement is the way to solve the problems of shirking, free-riding and other moral hazards. After analyzing the share systems in both capitalist and socialist economies, he proposed that the communal institution, which incorporated the residual claims and the monitor power, was an adequate form for socialist enterprises. It represents a prevailing idea of the feasibility of the adaption of share system to the socialist economy.

But there is still a problem. With the communal institutional arrangement, state enterprises are owned by the employees and that all share in the residual. Such general sharing in the residual results in losses from enhanced shirking by the monitor that exceed the gains from reducing shirking by residual-sharing employees. The communal institutional arrangement at last will lead state enterprises to the weak social ownership of the former Yugoslavia.

If in a socialist society, the introduction of share system gives each producer individual property (just as Marx suggested), then the general sharing of the residual will be replaced by specific sharing. And the property rights holders of the enterprise can organize together and set up mechanisms to monitor the problem of management shirking and prevent outsiders from sharing the residual.

Mester (1989) listed three ways to monitor the management: 1. by encouraging directors and managers to own stocks, 2. by increasing the power of outside directors to remove managers, and 3. by decreasing the barriers to takeovers.

Thus theoretically, the share system which clarifies the property rights, may be an adequate form of public ownership in socialist society.

CHAPTER IV

A Review on PRC's Enterprise Reform

Hua, Zhang and Ruo (1988) gave a detailed elaboration of PRC's enterprise reform with an emphasis on the criticism of the traditional public ownership and asked for new theories to direct the reform. In this paper, I stress the manager-supervisory institution relationship, since this relationship reflects the underlining property rights relationship.

4.1. The reconstruction of labour ownership

The experience of more than thirty years indicated that without external market competition pressure and internal incentive mechanism, the traditional state enterprises had operated inefficiently and the allocation of resources had been unreasonable.

The Chinese government has been implementing an enterprise reform since 1979. At the very beginning, in following the Yugoslavian experiences, China emphasized the reconstruction of labour ownership, which allowed employees-- the owners of productive materials-- to manage the enterprise directly. It adopted the contract system and executed the policy of expanding enterprises' autonomy. It also carried out various economic responsibility systems and established the manager responsibility system.

However, under the soft budget constraints, the transfer of power to lower level personnel caused an unreasonable expansion of enterprise investments and consumption funds. The retention funds of enterprises were increased at the expense of the decreases in the fiscal income. Moreover, the determination process of contracted profit again depended on the bargaining power of managers rather than on a scientific evaluation of the production potential of the enterprise. Thus the inequality among enterprises became much more acute.

From 1983 to 1984, the government adopted a new policy by levying various taxes on enterprises instead of taking over a certain amount of profits from enterprises. But there were still problems. Although the income tax rate for all state enterprises was identical at 55%, the adjustment tax rate was determined separately for different enterprises. Even in the same industry, different enterprises had different rates. Thus, such a tax system had intrinsic defects and the rate was determined through bargaining, manipulation of information and some under-table behaviours.

The logic of the reconstruction of labour ownership by taking each enterprise as a unit, is to achieve the unification of ownership and management. However, with increased power in making decisions of production, profit distribution and etc, the workers payed no attention to the value increase of the state assets. Instead, they just wanted to change the state assets into their individual assets. Salaries and other welfare expenses were kept at a high increasing rate at the expense of profit, development and technological innovation funds decreases. Since the workers knew that if the enterprise ran into troubles, the government would save it through various measures, thus they could take advantage from other people of the country.

In the fourth quarter of 1984, there appeared rapid expansion of investment and consumption and the macroeconomic was out of control (Zhao, 1985).

It's quite obvious that the labour ownership system can't solve the problem of low efficiency caused by the ambiguity of public ownership. The government launched the "manager reform".

4.2. The manager reform

In 1985, the government shifted its emphasis to the reconstruction of the micro incentive system by asking the managers to be responsible for the efficient use of the state assets. It intended to launch a "manager reform" within state enterprises. Systems of leasing, contracting and asset-management responsibility have been implemented. The government reduced administrative intervention on state enterprises while strengthening the manager's position and power in the enterprise. To ensure efficient use of state assets through providing incentives to the managers, the government asked managers to sign contracts with their supervisory institutions to guarantee the achievement of a certain level of annual profit. If a manager failed to meet the target, he would be fined or fired; if he succeeded, he would be awarded a certain percentage of the extra profit.

However, this lurks possibility of the return of the former system. Since profit contract is signed between the enterprise and its supervisory administrative institutions, thus it is still administrative intervention by the government.

The lack of competition mechanism in contracting, the assessment targets and the additional requisites set by the supervisory institutes further strengthen administrative interventions. The functional unification of the government and enterprises has been restored and even deepened (Hua, Zhang and Ruo, 1988).

4.3. Some outcomes of the delegation

Before the reform, all profits were taken away by the state. After the enterprise reform, enterprises can retain a part of profit. So the rate of profit retention (RT) indicates the profit distribution power of the enterprises.

Before the reform, the total amount of output was instructed and assigned by the supervisory institutions. After the enterprise reform, the enterprises' output consists of two parts: the instructed and the market determined output. So the degree of marketization (M) indicates enterprises' power in determining the output level.

There is a statistical analysis indicating that the composite factor productivity E of a Cobb-Douglas production function has declined from 0.53 in 1981 to -0.22 in 1987, while the enterprises' autonomy has been increased (Dong; Tang 1992).

From Table 1, we know that RT doubled from 16.54% in 1980 to 34.17% in 1987, and M increased from 50.76 in 1985 to 55.88 in 1987. These indicate that enterprises got more and more autonomy. But the composite factor productivity E kept decreasing from 0.53 in 1981 down to -0.22 in 1987. These results indicate a negative relationship between enterprise autonomy and productivity.

Table 1 Autonomy and Productivity

	RT (%)	M (%)	S (%)	E
1980	16.54	-----	-----	----
1981	-----	-----	-----	0.53
1982	-----	-----	-----	0.50
1983	21.81	-----	-----	0.25
1984	23.47	-----	-----	-0.46
1985	28.39	50.76	37.34	0.36
1986	32.58	53.58	40.98	-0.18
1987	34.17	55.88	42.90	-0.22

RT: the rate of profit retention = Profit retended / Gross Profit
M: the degree of marketization = 1 - Instructed output / total output
S: compound index of autonomy = 0.4M + 0.6RT

Sources: "State enterprises reform: institutions and efficiency" (Page 2, Page 4) (Dong; Tang 1992)

CHAPTER V

Share system: a prospect future

5.1. To liberalize the economic foundation

Up till now, despite the introduction of market-driven reform efforts through the contract system (including the reduction of instructed production proportion and the relaxation of price control), state enterprises are still under the informal control of state authorities and depend on both the market and the state. The enterprises still tend to have a weak interest in enhancing economic efficiency.

As mentioned before, decentralization of decision making even through market-driven mechanisms is of little use under the condition of a distorted price system and the soft budget constraints. The future of state enterprise reforms depends on reforming both the firm's budget constraints and market mechanisms.

Initial enterprise reform efforts in China were merely adjustments to the parameters set by the superstructure, that is, some form of administrative decentralization. Nevertheless, the economic foundation still has not been liberalized from the grasp of the superstructure.

Yang (1988) stated that the contract system, the backbone of the initial PRC's enterprise reform, did not transform the traditional ambiguous property rights system and failed to break the old distribution structure. He proposed that a share system could replace the contract system and to separate the macroeconomic adjustment function of the government from the state asset ownership. He also suggested that the earning function of state shares should be separated from the monitor function.

But, in the following analysis, I will argue that the most important thing is to liberalize the economic foundation from the superstructure and to deny the government the governance of enterprises.

By setting up a pure economic institution - the state asset investment company, which is independent on the government and reports only to the National Congress, and that the evaluation criteria of the company are related only to the increase rate of state assets value, then there is no need to separate the earning function from the monitor function.

5.2. Share ownership system

Share ownership has become respectable with the Chinese Communist Party almost by accident. In the post-1978 drive for economic reform, agriculture blossomed with a new-found freedom for the peasants to make economic decisions under the contract system. And villages started to establish township factories and transport firms, many of which were financed by cooperative shareholding, usually by members of a clan or a group of friends.

Along came the reform in cities with the introduction of contract system and market-oriented management in state-enterprises. The appetite of state and collective enterprises for commercial borrowing was being intensified while traditional bank credit became more and more stringent because of the shortage of funds and the fear of idle funds. So, more and more enterprises throughout China were anxious to advance from sole reliance on bank loans to other forms of funding for their operations, such as financing directly from the public (Hua, Zhang and Ruo, 1988).

The urban managers in the early 1980's watched the suburban share holding success enviously and made efforts to persuade local Communist Party into approving similar share ownership experiments in the towns and cities.

With reference to the fact that in the Western industrial revolution, the limited liabilities company with share issues played as important a role as the steam engine and the "bottleneck" of funds in the present reform, the government approved the share ownership experiment in 1984 to raise funds and to improve management and administration.

5.2.1. Purposes of share system reform

Liu (1986) pointed out the necessities for the adaption of share-holding system in socialist economy, and he listed the roles of share system as three-folded: 1. rationalize the behaviour of state enterprises, i.e. get rid of the soft budget constraints, 2. separate the government from the daily management of enterprises, 3. prompt capital movements to increase capital efficiency.

In 1991, the State Council stated that the purposes of introducing shareholding system in China are as follows (Bank of Communication, 1992):

1. To transform the management system in the existing state-enterprises with the separation of state ownership and the functions of the management.

2. To tap new financial resources, to raise construction funds, to change the consumption funds into production funds, to enhance the efficiency on the application of funds and to solve the financial bottleneck during the reform.

3. To improve the rational flow of production factors so as to achieve the optimal allocation of limited social resources.

4. To increase the profitability of the state-owned assets. Song (1990) refuted the idea that share system was only good for raising capital. He indicated that a share system specifies the property rights and according to Marxism, it was the "transition point" from capitalism to socialism. So the share system was considered critical to the success of the reform.

Share system is viewed as a measure to clarify the property rights relationship in China. It is expected to transform the traditional property rights relationship, construct a competitive market in which enterprises are under "hard" budget constraints. Share system also makes merger, takeover and bankruptcy available. It facilitates efficient allocation and usage of social resources.

5.2.2. Important factors in the application

There are three interdependent factors in carrying out the share system policies:

1. Through the transformation of property rights into share system, the property relationship of state enterprises will be clarified.

At present, due to inefficiency and the lack of capital market, the asset value of state enterprises is distorted and needs reevaluation according to their capital present value and real output potential.

Based on the reevaluation, property rights can be represented by share volume and finally there appears four kinds of shareholders:

A) Government holders: Shares are held by the government at different levels through investment companies. Dividends and capital gain consist of part of the fiscal income, so the government needs only care about the financial turnout and operational efficiency and effectiveness of the enterprises.

B) Corporate holders: Various kinds of funds can be established. With the investment in capital market, dividends and capital gains can be used to carry out social securities affairs.

C) Inter-enterprises holders: Through capital movement in the market, the allocation efficiency of capital can be enhanced and the industry structure can be improved.

D) Individual holders: With their investment in the enterprises, individuals can participate in the management and thus to monitor the operation indirectly.

The clarification of the property rights relationship changes the pattern of power distribution of the management. Each shareholder knows how much interest one has in an enterprise. And with the combination and balance of different goals of different shareholders, enterprises will be liberalized from administrative management and become profit- and market- oriented through efficient and effective operation.

2. With the construction of a capital market, mergers, takeovers and bankruptcies will be carried out more publicly and more reasonably. It provides an objective evaluation for enterprises' assets and their operations. This is a critical measure of the efficient allocation of capital.

3. With the establishment of state assets management institutions, such as the national investment companies, which are independent on the government and directly report to the National Congress, it will separate the superstructure completely from the economic foundation.

5.2.3. Some steps of share system reform

In order to improve the management of state-enterprises to set up a market-oriented economy and to enhance the social economic efficiency, the Chinese government has gradually not only transformed some state-enterprises into joint-stock style, but also set up new joint-stock enterprises.

According to the State Commission for Restructuring the Economy (Zhang, 1992), there were about 3,220 experimental share-holding enterprises of various types at the end of 1991. Eighty-nine of them openly issued shares to society, and the total value of their equity amounted to 5.81 billion RMB yuan (US$1.06 billion).

These 3,220 share-holding enterprises roughly come in three kinds:

(1): Employees-held shares, a system working in 2,751 enterprises.

(2): In 380 enterprises, people from the outside legally buy shares.

(3): The rest 89 companies sell shares on the open market.

We can also divide these firms into two categories:

(1): Floating shares to absorb social idle funds and establish new firms. All assets are from the floating, so the property title is clear and there is no need to appraise the original capital value.

These firms enjoy sufficient managerial autonomy and can learn much from western limited liabilities companies to operate successfully in the market and they are less constrained by the traditional administrative system.

(2): In order to improve the management of state-owned enterprises and solve problems incurred from the union of the state enterprises and collective firms, the government has approved some companies to become joint-stock companies and assets from the state, the collective and the individuals are to be merged into an organic whole.

The original state-owned capital stock was converted into shares owned by the state and the capital received from public issue was treated as the incremental part of capital.

"B" shares are also created as a special vehicle to allow foreigners to invest in Chinese shares. They are denominated in RMB and only can be subscribed with foreign convertible currencies by foreign corporations and individuals.

The "B" share experiment is tied to the reform of Chinese inefficient state enterprises. With the issue of "B" shares, an enterprise will be changed into a joint-venture. It is expected that this conversion will expose Chinese managers to international accounting and business standards and will provide an incentive to improve management.

It will also enhance the PRC's profile in international capital markets. Equity also represents a cheaper means of drawing in the much-needed funds while the risk is borne by foreign investors.

But whether the foreign investors can have a vote in determining the board of directors of those companies which issue B shares is still another problem. Otherwise, the introduction of western management will be delayed.

Up until now, the reasons for the adaptation of share system and the intended plan of share system reform of China's government have been discussed theoretically. But how about the actual implementation and the achievement? What kinds of problems have been solved and what kinds of problems still have not been solved by the share system? What kinds of new problems have been induced during the share system reform? With a case study, I intend to give brief answers to these problems and I hope that some insights of the adaption of the share system in China may be got.

In the case study, I first point out the ambiguous property rights relationship existed in the company before share system reform, and its results. Then I address the process of the share system reform and indicate the actual achievements so far. Finally with a terse analysis of its financial outcomes and interviews with its general manager, I point out the reasons why there is still soft budget constraint in the company's operation and existence of other problems.

CHAPTER VI

Case Study: Shanghai Feilo Company Limited

6.1. Introduction:

Feilo Company Limited mainly produces electric sound products, such as: Hi-Fi, earphones and etc. It is the first company approved by the government to experiment share system in Shanghai. Its experience of share system is typical and the problems it has encountered during this transition are worth analyzing. It underwent three system reforms from 1980 to 1987.

1. In 1980, in order to expand production capacity, the state-enterprise Shanghai 11th Radio Factory took over two collective enterprises of the same Bureau and set up Shanghai Feilo Electric Sound General Factory. After the takeover, the production was expanded, so did the profit. But there also appeared many problems.

First, there is a disorder of the assets belonging relationship. It was really difficult to coordinate two different accounting systems, one was for state assets and the other for collective assets. Thus all financial statements were prepared respectively and it was very hard to consolidate them since the items and rules of two accounting systems were different.

Second, there was a disorder of internal relationship. There were two corporates in one factory, one was for state assets and the other collective assets. And the supervisory institute administered these two corporates separately. Thus the disorder of internal management relationship was inevitable.

Third, there lacked a formal profit distribution system. It was hard to coordinate the benefits of the state, the company (collective) and the employees. Employees belonged to two different distribution systems, one was for state employees and the other for collective employees. This led to an unfair remuneration system, which allowed those state employees take advantages from those collective employees. The enterprise lacked the ability of self-innovation and self-development. Employees didn't share the benefits of the enterprise and had no impetus.

2. In 1984, the separation of ownership and management was experimented. With the approval of the People's Bank of China, Shanghai Branch, Feilo Factory set up a subsidiary company--Shanghai Feilo Acoustic Company Limited through public share issue. It was the first joint-stock company in Shanghai.

Feilo Acoustic Company operated so successfully that from 1984 to 1988, its assets doubled. The Feilo factory learned that share system prompted the enterprise to participate into the market competition, operate by itself and be responsible for its own profits and losses. The property relationship was much more clarified. The administrative subordination and intervention were weakened and the decision power belonged to the board of directors. The general manager was responsible for daily management. The enterprise faced the market directly and there was no planned production target. The company had large flexibility in operation. Every employee owned a certain number of shares and the interests of the employees and the company combined together.

3. On September 3rd, 1987, Shanghai Feilo Electric Sound General Factory was transformed into share system and the Feilo Company Limited was founded. On September 8th, it offered public share issue and the company was listed on the Shanghai OTC trading centre on April 18th, 1988.

6.2. The process of transforming the share system:

1. Clarify the property relationship:

a. The structure of share ownership:

The company assets consists of state, corporate and individual shares. The state fund (including the reevaluated fixed assets and state allocated current funds) is changed into state shares. The collective fund, together with investments from other companies, is changed into corporate shares. The shares subscribed by employees and the public are individual shares.

b. Evaluation of the assets:

Through evaluation, the company separates the state assets and collective assets.

First, ask the Municipal Fiscal Bureau and Municipal Accounting Agency to formulate the evaluation policy and principles.

Second, authorize the Accounting Agency to evaluate the assets.

Third, according to the evaluation results, the company determines the amount of state shares and corporate shares.

c. Share issue:

Determine the amount of investments from other corporates and the public. Through the recognition of the property, the total share value is 25 million yuan (state: 50%, corporate: 40%, individual: 10%).

2. Set up reasonable distribution relationship:

a. Regulate the profit distribution order: First, pay income tax. Second, pay back the technology innovation credit. Third, pay the fund of major energy and transportation construction. Fourth, distribute the remained profit and divide it into production & development fund, employees welfare & reward fund, dividend & bonus fund, and bonus reserve fund.

b. Implement tax system reform, separate tax from profit. First, delete the adjustment tax. Second, income tax rate drops from 55% to 35%. Being the government, the state collects income tax from the company; being the owner of the state assets, it also receives dividends and bonuses. Thus the distribution relationship between company and the state is clarified. This can lead to the separation of administration function from the asset management function of the government, and it helps company to achieve the separation of ownership from management.

c. Change pay-credit-before-tax into pay-credit-after-tax.

When the company pays credit before tax, in fact, the state bears the main burden of paying credit. After the set-up of share system, the company should be responsible for its own investment, so the government regulates that it only can pay credit after tax.

d. The distribution of after-tax profit is determined by the board of directors.

3. Set up a management system with the "separation of two powers":

a. The obligations of shareholder conference are: first, discuss the annual report of the board; second, discuss the financial budget reports offered by the board.

b. Set up the board of directors. It is the decision-making institute. The directors from state and corporates are designated by those institutes. The directors from individual are designated through the negotiation between the company and the representatives of individual shareholders. The obligations are as following:

First, it is responsible for the appreciation of the company's assets value.

Second, it makes investment decisions.

Third, it determines the distribution of after-tax profits.

Fourth, it hires and fires the general manager.

c. Implement the general manager responsibility system. The general manager is the corporate of the company and is responsible for the production decision-making and daily management. He is under the direction of the board.

6.3. Financial outcomes of the company:

From the table, we can find a problem. During the low profit period (1989-1991), the company's scale (according to Assets) kept increasing at an annual rate of nearly 20%, but its equity kept decreasing at an annual rate of 5%. This means that in an adverse business environment, it still has impetus to expand its scale and relies more heavily on the credits. Is there still a soft budget constraint?

Table 2 Performance of Feilo Co. Ltd.

Unit: RMB M

	1988	1989	1990	1991	1992
Face value of shares	21.01	21.01	21.01	21.01	48.66
Assets	----	103.488	114.144	148.678	276.797
Equity	----	26.518	25.26	24.281	181.214
Profit	6.2	2.478	0.42	1.867	10.527
After-tax profit	4.43	1.705	0.357	1.765	8.948

Source: Annual reports of Feilo Co. Ltd.

6.4. Problems of the new system:

Based on the interview with its general manager, I find that the management system has retained the traditional state-enterprise model, with only limited adjustment. There's a sense of "the same old stuff with different label".

a. Right now, the eight directors consist of those original enterprise's managers, the officials of its supervisory department and managers of other companies which hold this company's shares (based on the interview with Qin). The management principle is to achieve a balance of different partner's power, so the decision-making power in the board is dispersed.

b. There are too many directors and six directors from supervisory institutions and other companies are part-time, so the board exists in name only. The general manager, who is also the vice-chairman of the board, arrogates all powers.

c. The officials from supervisory institutions take positions in the board. They are the representatives of the state shares and also are the managers' immediate superiors, thus the management is still under the administration intervention. And the managers' career path is still the bureaucratic status. Then there is a return to the traditional system and there still exists soft budget constraint.

d. The representatives of other companies only behave on behalf of their companies' benefits and ask for high level of dividends and bonuses. This prompts the company to take short-term actions and reduces the retention funds. From table 2, we see that the equity kept decreasing from 1989 to 1991. During that period, the company's business was not good, the profit kept dropping. But the dividend and bonus rate was 20% in

1988, 18.75% in 1989 and 12.5% in 1990. The increase of equity in 1992 is only due to the premium gained from the new stock issue.

The company should have independent operational management power, but its administrative affairs are still under the control of its supervisory institutions. This kind of distorted internal management system makes the company lose independence in the management of daily management.

For example, the nomination, transfer, check-up, rewards and penalties of the company's cadres are under the supervisory institutions' administration, the company cannot determine all those things by itself.

In human resource management, the regulated number of employees is set by the Labour Bureau; in the salary management, the salary level should be referred to the supervisory institutions and the sum of salary should be allocated by the Labour Bureau.

CHAPTER VII

Conclusion

The origin of inefficiency of state enterprises lies on the ambiguous property rights relationship of the traditional state ownership. Thus, in order to improve the operation of state enterprises, there is a need to specify the property rights and change traditional general sharing of residual into specific sharing.

The share system reform is recommended to specify the property rights in PRC. With the introduction of share system, an economic "governance mechanism" can be set up to replace the traditional political one and separate the government from enterprises.

The most important thing the joint-stock companies should deal with is how to use the huge amount of money from the share issue that is raised efficiently and reasonably. It's a true progress that the joint-stock companies now have their own responsibility to formulate their own business strategies.

Before the enterprise reform, state-enterprises just executed the policy set up by their supervisory companies or bureaus, so at present there is still a lack of experience in developing business strategies. Compared with daily management, the ability of strategic management of joint-stock companies is relatively weak. Meanwhile, because of the high speed of the transformation of share system, some companies found it difficult to find out the direction of their future development and stipulate their own strategies in a short time. Thus some companies adapt share system simply for raising more capital while the transformation of management from traditional state-enterprises to joint-stock companies has been neglected.

There're several common characteristics of the strategies of joint-stock companies:

1. Similarity of investment direction. Many companies concentrate on the real estate market and the securities market, mainly stocks.

2. Strategic diversification investment has occupied a high proportion.

For example, the Feilo Company Limited invested more than seven million RMB yuan in 1992 in setting up one real estate company, one trading company, one taxi company, one department store, one fashion company and etc.

3. Limited funds invested into technology development. Little has been allocated to technology development and innovation so as to expand the production of the companies' traditional products (*Shanghai Security Weekly*, June-July 1992). Many joint-stock companies are manufacturers, but they seem to have little confidence in their industry and are instead attracted by the high profit margin of the emerging service industry.

As the case study indicates, there are still control from supervisory institutions. Conflicts with supervisory institutions are inevitable in daily management. Two steps should be taken to transform the management system:

(1). Deny the government the governance of enterprises

In order to solve problems related to those supervisory institutions, it is recommended:

(a). Completely change the supervisory management system.

A specific joint-stock company assets investment company should be set up. It is an economic entity with main responsibility to assure that the state-assets can appreciate as quick as possible, at least in par with those collective and individual assets of joint-stock companies. That is to say, the goal of supervision is to maximize the companies' long-term profits. As the representative of the owner of the state shares, the investment company is responsible for the appreciation of state assets.

(b). Adopt the general manager responsibility system. A general manager responsibility system under the reference of the board of directors should be implemented to improve human resource management. The general manger should have the final say in hiring and firing employees. And the company's employment and remuneration policy should be laid out by the company itself. The government should be hands off from all these management issues. The government could focus on managing the economy through the use of macroeconomic leverages.

(B). Strengthen the function of the board of directors.

In order to strengthen the decision-making power of the board:

(a). There should not be any government political officials in the board, instead the state assets investment company which is an economic entity can send people to the board. Thus, a complete separation of the government and enterprise can be achieved.

(b). Set up the standing board of directors and adopt the system of two-level directors.

(c). Clarify the interest mechanism of the board and relate it to the company's operational benefits, so as to strengthen the board's responsibility and ensure the long-term development of the company.

(d). Invite experts who have no financial interest in the company to be consultants or non-executive directors.

As to the future development of share system, Hang (1986) listed the coupling conditions for the adoption of the share system:

1. a well-organized stock market, 2. comprehensive economic regulations and laws, 3. the use of indirect means in government macroeconomic adjustment, 4. an open capital market, 5. the set-up of state assets investing companies.

Although the paper was published seven years ago, it still enlightens the direction of the share system reform.

The adoption of a share system in socialist China is unprecedent and a lot of improvements are desired. It has transformed enterprises into market-driven ones and is taking a giant step forward in the separation of ownership and management.

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